This impact of competition on costs must be interpreted with one general caveat, however. Although competition produced mixed results in reducing administrative costs for individual solicitations, the existence of competition may have focused attention on the reduction of administrative costs and may have served as an intangible stimulus for all cost-reimbursement contractors to minimize administrative costs in order to avoid competition. Although the cost estimates from individual solicitations may not indicate significant savings from competition, the indirect and unmeasurable effects of competition on all contractors may have reduced the total cost of program administration during the period of the demonstration projects.

In recent competitions, however, few bids to perform administrative activities have been submitted. This decline of contractor interest in competition is expected to continue in the near future, making large administrative savings from competition unlikely. It is thought to reflect contractor perceptions of the large financial risk and limited financial gains because of declining reimbursement under the current system, as well as aspects of the procurement process in the award of contracts.

The following section examines the theoretical mechanism by which administrative costs might be reduced under a competitive award and the aspects of the procurement process that would encourage and discourage

potential contractors from entering competition. This section is followed by a detailed discussion of the results the competitively awarded, fixed-price demonstration projects and the possible implications of these findings for other competitive situations.

Potential Effects

When implemented with a fixed-price contract, competition has the potential to provide a superior or comparable product at a lower cost. Including cost as a selection criteria for contractors would place greater emphasis on cost-efficient management than the current system. Contractors might be forced to direct more attention to the level of work and the management strategies that they would employ to meet defined performance standards while remaining competitive. These market pressures might ultimately reduce Medicare administrative costs.

Competition might force contractors to consider one or more strategies to reduce administrative costs. First, management could improve the overall productivity and performance of its existing labor force. 2/ Second, new technological systems could be implemented to streamline

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2. Managerial strategies that could improve performance and reduce costs using existing resources include financial incentives to increase worker productivity, advancement programs to encourage worker longevity and superior performance, creative use of worker schedules, ongoing training to provide skills necessary for high productivity, limited use of overtime, or targeted recruitment based on characteristics of workers identified with good and extended work tenure.

administrative operations and reduce labor costs. "State of the art" and other less radical modifications to contractor systems, such as the subcontracting of data processing activities or automation of correspondence, when appropriate, could significantly improve the overall efficiency of an existing system.

Third, contractors could bid on only the incremental costs associated with expanding existing managerial and claim-processing systems for Medicare services, rather than on the costs derived from allocating the fixed costs of production proportionally to Medicare and private business claims. This marginal cost pricing policy could considerably reduce Medicare contract costs. 3/ Fourth, contractors could reduce labor costs by establishing the base of operations in rural locations or other areas with cheaper labor and lower overhead costs.

Competition could provide a mechanism through which other administrative initiatives might be implemented. Many changes could be achieved

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3. This argument for competition assumes that the existing system for private business claims processing could be easily modified and expanded to accommodate Medicare claims. Regulations on contract specifications that create dissimilarities between Medicare and private business claims might violate this assumption, however. Examples of the types of restrictions in existing fixed-price contracts include requirements for a specific claims format and billing and coding systems, or the limitation on the location of claims-processing activities.

using the existing provider-nomination system, such as consolidation of territories to achieve greater economies of scale, introduction of new technologies, improved performance standards, or the integration of HI and SMI administrative systems. Competition might aid such changes by eliminating some of the resistence that has been expressed by the contractor and provider communities to implement such changes under the existing system.

In addition, contractors outside the specific area subject to competition might try to improve their performance in order to prevent the competitive award of their contract and the challenge by competitors with superior capabilities.

On the other hand, the perception of limited financial advantages of the contract might discourage many potential bidders, possibly negating the intended impact of competition on administrative costs. The fixed-price contract would not guarantee "no loss" and, unlike the existing system, the contractor would have to weigh potential financial gains relative to potential losses to determine the appropriate use of corporate assets. 4/

4. Efficient organizations are in a position both to bid lower costs to obtain the contract and to gain from it, and may also realize more financial gain since they need not transfer all of the gains from their greater efficiency to the government by lowering their bids to their actual costs.

While many of the indirect and nonfinancial incentives for participation would exist, potential financial loss might be weighed most heavily. 5/

Such a reluctance to bid might result, in part, from assigning the total financial risk for fluctuations in claims workload to the contractor as required by the total-sum, fixed-price contract. Competitors might choose not to compete, since they would be unable to bid the full value of contingency costs for unanticipated events for fear of being underbid, and disinclined to exclude these costs because of possible financial losses.

The relative emphasis given to each of the selection criteria might also affect the number of bidders. Although bidders do not formally state their willingness to compete prior to the submission of proposals, the contractor community is aware of other firms that may enter the competition and, in general, their standing relative to these others. 6/

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5. The nonfinancial advantages of the Medicare administrative contract include: the positive product affiliation of the contractor's private business with the Medicare program (especially for Medigap, the private, supplemental medical coverage for non-Medicare reimbursed expenses); the additional leverage in negotiations with providers when implementing general corporate policy; the testing of new claims-processing procedures and technologies prior to use with private business; and the financial stability which may be achieved when Medicare constitutes a large proportion of contractor's total business activity. Other reasons for participation include corporate goodwill and an interest in influencing general Medicare policy to safeguard the contractor's own business interests.

6. This awareness, in part, comes from a bidders' conference in which potential contractors are gathered to clarify aspects of the contract solicitation collectively.

Potential bidders would assess their corporate strengths and weaknesses relative to the selection criteria, and, more importantly, to other firms they feel are likely to compete. 7/ Firms feeling that they are noncompetitive might not compete because of the costs associated with proposal development.

The perceived advantage of a competitor on technical merit and experience or the perception that there will be few other competitors might increase the price of the bid. Conversely, a larger number of bidders or the perception of a "tight" competition might reduce the cost bid by each competitor, reducing the value of the contract award to competitors. This administrative cost reduction is desirable for the federal government, if performance on other key measures can be maintained.

Actual Experience

Since 1977, HCFA has initiated seven competitive, fixed-price contract demonstration projects for the selection of Medicare contractors. 8/

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7. The points assigned to the selection criteria--experience, technical merit, and cost--determine the relative advantage of one firm over another. High points for cost, for example, would generate interest from firms with limited experience in the field but whose costs are low, for example, because of having adopted new technologies. Alternatively, high points for experience might encourage those firms with good and extended performance on other contracts, thereby excluding or discouraging inexperienced firms.

8. The seven competitions have included six territories; one fixed-price contract area, Maine, was recompeted at the conclusion of (continued)

The demonstrations have implemented only total-sum, fixed-price contracts. Each contract has been awarded to provide administrative services for a three-to-five year period. These contracts have included liquidated damage clauses in which substandard work reduces contractor payment. The most recent contracts have also incorporated financial incentives for performance that exceeds specified standards. 9/

The competitive fixed-price demonstrations have produced mixed results in reducing administrative costs. 10/ When measuring differences between the actual fixed-price and a projected cost-reimbursement contract price, half the demonstrations realized administrative savings and half increased administrative costs (see Table 2). In one instance, however, the

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8. (continued) the first contract. Bids for an eighth solicitation, the recompetition of the Illinois SMI contract, have been received and are being reviewed by HCFA.

9. Payments for administrative services involve three major cost functions: transition costs required to design and establish all systems in the contract territory, operational costs, and negative costs for liquidated damages. Liquidated damages will not be included when determining administrative savings in CBO estimates of administrative cost savings as poor performance cannot be predicted, should not necessarily be anticipated in future procurements, and merely represents an inferior product, not an actual savings.

10. Administrative cost estimates derived from the competitive fixed-price contract assume the comparability of contractor responsibilities under the cost-reimbursement and the fixed-price system. It should be noted, however, that contractors under the existing system are expected to perform all activities requested by HCFA; contractors awarded business under a competitive fixed-price arrangement are bound only by the language and requirements of the contract and additional work or changes in responsibilities require contract negotiations and modifications.

TABLE 2. ESTIMATED ADMINISTRATIVE COST SAVINGS FROM COMPETITIVE FIXED-PRICE CONTRACTS

Area	Type	Estimated Savings a/ (Dollars in thousands)	Savings as Percentage of Projected Costs	Number Compe-titors	Other Potential Explanatory Factors
New York	SMI	10,591	34	6	Consolidating 3 territories into one
Illinois	SMI	10,873	25	5	Consolidating 2 territories into one very large terri-tory
Maine I	SMI	739	13	5	Minimal changes; no consolidation
Maine II b/	SMI	-1,306	-30	2 c/	Minimal changes; no consolidation
Missouri	HI	-1,844	-35	2	Consolidating 5 territories into one
Puerto Rico	HI/SMI	Now awarded because of high bid	--	1	Consolidating HI/SMI
Colorado	HI/SMI	Not available	Not available	1	Consolidating HI/SMI

a. Negative sign denotes additional cost to federal government. Estimated for the entire period of the contract.

b. The Maine I fixed-price contractor was awarded a second fixed-price contract in the recompetition of the Maine II contract and the continuity of staff and operations was maintained.

c. Initially, three competitors; one withdrew bid.

competitive fixed-price bid was so high that the contract solicitation was withdrawn by HCFA.

The administrative savings that have been realized occurred after the first year of fixed-price operations. During the first year, the costs of establishing program operations were substantial and offset any administrative efficiencies. 11/ These costs were incurred partly because of the necessity to maintain the cost-reimbursement contractor to process claims while the fixed-price contractor established new operations during the transition period. Cost increases for claims processing during the first year were, on average, more than 30 percent greater than those which would have been experienced by the incumbent contractor. In subsequent years, however, costs were reduced considerably, producing an average, net, overall savings of approximately 10 percent for the SMI fixed-price solicitations.

Number of Competitors and Administrative Savings. The level of competition, as measured by the number of competitors, significantly affected the administrative costs of contracts awarded under the competitive fixed-price process. In solicitations with multiple bidders, the

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11. Transition costs will be incurred by all contractors regardless of previous Medicare administrative experience because of the need to establish new operations, hire and train a new staff, develop a new computer system, and perform other developmental activities in a new site.

cost of the contract was considerably lower than the projected costs of the incumbent contractor. Solicitations involving one or two bidders demonstrated significant increases in administrative costs or were not awarded because of high bids. The behavior of the incumbent cost-reimbursement contractor paralleled that of other competitors: incumbent contractors reduced fixed-price cost per claim below cost-reimbursement rates when large numbers of contractors participated in the solicitation; with limited competition, the fixed-price cost per claim increased.

Strong contractor interest in competing for Medicare contracts was observed in the initial solicitations. Competitors included Blue Cross/Blue Shield affiliates from the state of the contract, Blue Cross/Blue Shield affiliates in other states, commercial health insurers with other Medicare experience, and, in one solicitation, a data processing firm.

In recent competitions, only one or two competitors have entered each competition. These competitors represented primarily the local incumbent Blue Cross/Blue Shield affiliates (see Table 3). It appears that while some incumbents may be willing to compete for their existing territory under current conditions, Blue Cross/Blue Shield affiliates and commercial health insurance corporations may be uninterested in expanding their responsibilities beyond their current areas.

TABLE 3. NUMBER OF COMPETITORS BY TYPE

Area	Calendar Year Awarded	Local Blue Cross/ Blue Shield Affiliate	Other Blue Cross/ Blue Shield Affiliate	Commer- cial Health Insurer	Data Proces- sing Firm	Total Number of Com- petitors
Maine I	1977	1	2	2	0	5
New York	1978	1	0	5	0	6
Illinois	1978	1	0	3	1	5
Missouri	1980	2	0	0	0	2
Colorado	1980	1	0	0	0	1
Maine II a/	1981	0	2	1 b/	0	2
Puerto Rico	1982 c/	1	0	0	0	1
Total		7	4	11	1	23

a. The Maine I fixed-price contractor was awarded a second fixed-price contract in the recompetition of the Maine II contract and the continuity of staff and operations was maintained.

b. Withdrew bid.

c. Contract not awarded.

In addition to the general factors mentioned above, lack of interest may have reflected losses to contractors in the early fixed-price contracts 12/ and the recent ceiling on payments in cost-reimbursement contracts. The latter has led the contractor community to be uncertain about future involvement in the Medicare program even under a cost-reimbursement arrangement. Because the price bid for a competitive contract is based on the efficiencies derived from the expansion of existing operations, contractors might be unwilling to bid for additional contracts if they are considering curtailing or discontinuing their Medicare participation. This concern is voiced particularly among commercial health insurance corporations.

Generalizing from the Experience

The results of these demonstrations must be interpreted with great care when predicting future administrative savings or costs, because of unique aspects of the demonstrations. First, in several instances, structural and methodological changes included in the demonstration contract may have, by themselves, affected the contract's cost. In several demonstrations, considerable economies of scale may have been realized through the consolidation of territories. These economies may have led to overstated estimates of the savings realized from the competition alone.

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12. GAO estimates of contractor bids relative to work required indicate a financial loss by the contractor on the Maine I and New York SMI fixed-price contracts. The Illinois demonstration was estimated in 1981 to have cost the contractor $8.9 million over the $41.8 million awarded for the contract.

Second, estimates are necessarily based primarily on the Maine I, New York, and Illinois demonstrations, which produced the greatest administrative cost savings. The Missouri data provide only the transition and early operational costs, Colorado has yet to be implemented, and Puerto Rico was withdrawn because of the high bid. Early projections of administrative costs indicate high costs for these later demonstrations; the withdrawal of the Puerto Rico solicitation may, in particular, contradict the savings trend of the earlier competitions.

Also, some contractors may have underbid in an attempt to acquire the territory for corporate territorial "positioning" in the advent of the passage of a National Health Insurance plan, the regionalization of Medicare contractor responsibilities, or other Medicare fixed-price contract solicitations. To the extent that this occurred, "savings" could be only a transitional phenomenon.

COMPETITION AND ADMINISTRATIVE PERFORMANCE

The administrative performance of a contractor can be measured on three representative program dimensions: the timeliness of claims processing, the accuracy with which benefits are paid to eligible program participants, and the rigorousness with which the contractor reviews claims to ensure they are reimbursed for medically necessary services. The assessment of the accuracy of benefit payments--the payment deductible

error rate--measures the rate of reimbursement relative to individual coinsurance, program deductible, and eligibility status; the review for medical necessity compares a submitted claim to a medical record to establish the appropriateness of the claim. Contractors retain considerable discretion over the allocation of resources and the stringency of the review of claims to verify medical necessity. Differences in payments resulting from differences in the standards and policy interpretation of individual contractors on medical necessity reviews are not considered errors and are excluded from the payment-deductible error rate.

In the demonstrations described above, fixed-price contractors experienced temporary disruptions in the timeliness and accuracy with which claims were processed relative to the incumbent contractor. The period of disruption on the timeliness measure was relatively short; contractors generally achieved the incumbent's standard within a year after the assumption of responsibility.

Fixed-price contractors were less successful at accurately determining and reimbursing claimants for medical expenses. Initial payment error rates for fixed-price contractors were more than double those of the incumbent and remained high for almost two years. This increase in the payment error rate affected beneficiaries and providers of health-care services and, because overpayments exceeded underpayments, increased the expenditures for the program's benefits.

Lastly, the average benefit paid to each enrollee remained, on average, slightly below the expected payment for the demonstration site population. Payments to beneficiaries varied considerably in each of the three demonstrations, however. The implication of this variation in benefit payments for future competitions is unclear and the adequacy of resources devoted to benefit safeguards that were allocated under the fixed-price contracts remains unresolved.

The next section examines the effects of competition on contractor performance; this analysis focuses exclusively on the SMI contractors because data are not yet available from HI demonstration contracts. After a description of the measures that are used to evaluate contractor performance, potential positive and adverse effects of competition on contractor performance are discussed. The last section describes the actual experience under the demonstration projects.

Measurement of Administrative Performance

The **timeliness of payment** measures the speed with which the contractor processes and pays for a claim submitted by an individual or an institution. One measure of timeliness is the average number of days reported by the contractor to process a claim. Technological advancements have reduced the time required. Currently, an average carrier processes a claim with 11 days after receipt.

Delays in the payment of claims may create unnecessary cash flow difficulties for institutions and economic hardships for beneficiaries who may have paid for medical and hospital expenses from household assets prior to submitting the claim for reimbursement. Serious delays in payment have increased complaints and inquiries to the contractor by Congressional representatives and by beneficiaries in the past.

The **accurate payment of benefits** ensures that benefits are targeted to beneficiaries as intended in the authorizing legislation and the implementing regulations, at levels which are consistent with established reimbursement procedures. A measure assessing the number of payments made inaccurately is called the payment-deductible error rate. 13/ A large error rate appears to increase benefit payments, since overpayments have exceeded underpayments. 14/

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13. The payment-deductible error rate computes the dollar value of overpayments, underpayments, payments to those ineligible for the program, and payments based on inaccurate deductible and coinsurance information. Only errors attributable to the carrier are included in this measure. The error rate is determined from a review of a sample of claims dispensed by the contractor.

14. Since overpayments exceed underpayments by 16 percent, an additional one dollar paid inaccurately would increase program expenditures by 16 cents.